

INTERGOVERNMENTAL TRANSFERS TO LOCAL GOVERNMENTS: ISSUES AND EVIDENCES FROM ALBANIA

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ABSTRACT

Central government as well as the local government offers public services to citizens, but local units often face difficulties in financing certain functions, considering the growing need for investments. This gap is met by transfer of funds from central to local government. Municipal finance management is an important issue in Albania nowadays. Moreover, the determination of transfers is of critical importance to the success of decentralization process. The mechanism of intergovernmental transfer must resolve two key issues: determining the total fund to be transferred to local government and allocation of this fund to each local unit according to the specified formula. The determination of the total transfer fund in Albania is yet unfounded on a fixed scheme, while its distribution to local governments is subject to a formula defined in the budget law each year. Hereby, the ability to predict the funds by local government units is limited; one factor is the annually change in the total fund and the other one is the adjustment of formula coefficients. The purpose of this study is to analyze the system of intergovernmental fiscal transfers in Albania, with focus on the unconditional transfer, by identifying problems and opportunities for improving the system, and also to draw attention for further studies in the field of intergovernmental finances.

KEYWORDS: Intergovernmental Finance, Unconditional Transfer, Local Government Revenues, Decentralization Process, Fiscal Equalization, Local Autonomy, Transfer Allocation

INTRODUCTION

Albanian intergovernmental finance system relies on two components, transfers (conditional and unconditional) and own income of local government. This is unusual, because most European countries widely use a third component, shared taxes, especially common tax on personal income. Up to 50% of local budgets in Albania depend on central transfers. At a time when local governments are still involved in the process of decentralization, central transfers constitute an important source of revenues.

The concept of unconditional transfer is defined as a general budget fund distributed to the local government, on the purpose of fulfillment and management of its functions. The unconditional transfer funds are distributed through a formula, which is part of the Budget Law. The primary variables that determine the amount allocated to each municipality or municipal district are: population (which is the most important criterion), urban services and the area (only applies to municipal districts).

By definition, the main objective of the unconditional transfer is to equalize resources among local government units. Regarding the equalization objective, the formula faces a problem because the tax capacity of local units is measured

under current income of two taxes and it is not based on the real tax capacity. Meanwhile, the equalization coefficients should be more stable and the equalization must be based on real tax capacity of the local government.

In our country, the determination of the total transfer fund to be allocated to local units is still not based on a clear scheme. This amount is determined during the process of preparing the state budget each year. After determining the fund, the amount is then divided among local governments under the formula, the coefficients of which have permanently changed in recent years. So the ability to predict the funds is bounded; one factor is the change in the total fund allocation and the other one is the adjustment of formula coefficients.

Intergovernmental fiscal transfer is a crucial compound of the decentralization process of each country. Fiscal decentralization and the fiscal capacity growth of local units, is considered to be an important objective of decentralization reform and a prerequisite for the exercise of local autonomy and independence of local government in Albania. The principle of decentralization is the fundamental principle upon which the local government operates; it is a process in which authority and responsibility for certain functions is transferred from central to local government.

The underlying principle of decentralization is formulated as: "the exercise of public responsibilities should in general belong more to the authorities closer to the citizens." Although the allocation of intergovernmental transfers is somehow settled, there are still some problems and issues to be addressed.

LITERATURE REVIEW

The concept of intergovernmental transfer was initially introduced by economist Pigou in 1928; according to his study, the fiscal redistribution can help create equality of the welfare system (expressed in his research on public finances in 1928). As published in Oates thesis (1972), the central redistribution of income is a process that leads to higher levels of government.

Taking into account the rights and autonomy of local authorities, the European Chamber of Local Governance states that local authorities must have the freedom to exercise the implementation of social and economic policies of their jurisdiction through the use of grants transferred from the central budget. Intergovernmental transfers are a major source of income for local leaders in most developing countries (World Bank Report, 2007). These transfers are attributed important function of providing efficiency and fairness in the provision of social services and well-functioning governance at the local level.

The main reasons for the use of grants as stated by David King (1984), are explained as follows: firstly, grants serve to correct externalities generated by projects that include a certain area; secondly, to balance the level of derived taxes and revenues with the citizen needs for public services; thirdly, it is introduced the concept of equalization grants to mitigate fiscal disparities in incomes of different regions. Although in different countries exists unique systems for the fund allocation, depending on the various policies that a certain government follows, in general there are two fundamental forms of transfer: general and specific. They respectively mean; a grant for a specific purpose and a grant to be used for various purposes of public funding of locality itself and in the judgment of the local governing unit (Stephen J. Bailey 1999).

As mentioned above, the concept of intergovernmental transfer is highly related to the process of decentralization. This is explained by the fact that the transfer to local level is carried out to ensure the autonomy of local government, a necessary condition formulated in the decentralization reform. According to Bailey (1999) there are three forms of

decentralization: economic, political and administrative. For many countries and in particular for developing countries, decentralization and local governance itself are taking an increasingly important role, apparent in undertaken administrative and political reforms. Countries such as Bolivia, India, the Philippines, Colombia and Brazil have practiced the initiative of delegating some function of the central government to the local governments, in order to better distribute the workload and also to enable higher results in providing public services by the local units.

The most important reasons for decentralization are related to the concept of efficiency. According to Stigler (1957), as closer as a government is to its citizens as better it performs. Musgrave (1959) divides the government functions as: a) macroeconomic stabilization and economic growth, b) the optimal redistribution of income, c) efficient allocation of resources or factors of production. Oates (1972) formulated a theorem of decentralization stating that: "Every public service should be provided by the jurisdiction having control over a minimum geographic area that would internalize benefits and costs of such provision"

From previous studies in our country, it appears that Albania undergoes an asymmetric decentralization (treatment of different units in different ways). Such a policy creates conflicts between the central and the local governments or between different local units, especially of those local units that generate high revenues in the state budget (M. Veliu 2012). On the other hand, even though it is aimed towards more transparent and well defined practices of fiscal decentralization, as in the case of unconditional grants distribution by formula, yet the method of distribution and the amount of total fund is not specified in the medium term plans and especially in the long term plans of the government (O. Mucollari 2010).

METHODOLOGY

The purpose of this study is to analyze the system of intergovernmental transfers in Albania in relation to: the decentralization process development, equalization of fiscal transfer distribution system and meeting the criteria of local autonomy. The main focus of the study will be on the unconditional transfers and the distribution formula of this fund.

Research Questions

- Is the unconditional transfer fund consistent in years and does the system enables the predictability of resources for the local budgets?
- Does the formula of unconditional transfer distribution meet the criteria and general accepted principles of the public finance theory?

Analyzed Data

This study is based on secondary data. The collected data refer to official statistics of public institutions such as Albanian Institute of Statistics, Ministry of Finances, Bank of Albania and World Bank.

Time Interval of the Study

The interval of the study will be the ten year period 2003 – 2013. Additional data prior to this period are also taken into consideration, for those statistics relevant to the study or in the case of significant changes that also affect in the analysis.

Methods of Analysis

Descriptive statistical methods will be used to perform the data analysis of the thesis. More specifically: percentage analysis, standard deviation, coefficient of variation, correlation, and interval analysis of data. The research analysis is mainly based on given data: the legislation that regulates central grant system and numerical statistics that indicate the performance of variables in years.

RESULTS

In our country, the unconditional transfer fund was first presented in 2001, but starting from 2002 it was distributed according to a predetermined formula. The total transfer is determined annually during the budget preparation process, and then it is allocated to the local government units according to the formula provided in the budget.

Estimation of the Total Transfer Fund and Local Revenues Indicators

The percentage of unconditional transfers fund to the state general budget changes over the years, as it can be observed in the table below. There is no fixed formula to determine the total fund in relation to the state's general budget. The total amount to be transferred to local governments depends on the priorities of central government and the country's fiscal condition. Therefore, the adjustment of central government priorities affects the amount of transferred funds to local budgets. The method of determining the transfer fund is uncertain and it is determined in the organic budget law each year.

Table 1: Relevant Figures for the Transfer Fund and Local Revenues Changes in Years 2004-2013

	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
General Domestic Product	1430920	1389791	1335104	1278693	1180000	1075718	982200	899700	918,105	822677
Change in % of GDP	2.96%	4.10%	4.41%	8.36%	9.69%	9.52%	9.17%	-2.00%	11.60%	-
State Budget Revenues	360661	355759	362223	324891	298981	291238	251555	229444	204163	184355
Change in % of Budget Revenues (from year to year)	1.38%	-1.78%	11.49%	8.67%	2.66%	15.77%	9.64%	12.38%	10.74%	-
Unconditional Transfer (a)	12153	11576	11572	11340						
Conditional Transfer (b)	2000	2300	2900	5935						
= Grant of Local Government (a+b)	14153	13876	14472	17275	18423	13984	12625	10100	7300	6277
Change in % of the Grant	2.00%	-4.12%	-16.23%	-6.23%	31.74%	10.76%	25.00%	38.36%	16.30%	-
Own revenues of the Local Government unit (c)	12003	14624.2	17300	20948	18412	15582	13214	11216	10355	9287
Revenues from shared taxes (d)		1003								
=Revenues of the Local Government (a+b+c+d)	29256	29503	31772	38223	36835	29566	25839	21316	17,655	17,621
Change in % of local government revenues	-0.84%	-7.14%	-16.88%	3.77%	24.59%	14.42%	21.22%	20.74%	0.19%	-
Total revenues of Local Government as % of GDP	2.04%	2.12%	2.38%	2.99%	3.12%	2.75%	2.63%	2.37%	1.92%	2.14%
Own revenues of Local Government as % of GDP	0.84%	1.05%	1.30%	1.64%	1.56%	1.45%	1.35%	1.25%	1.13%	1.13%
Total local revenues as % of State Budget	8.11%	8.29%	8.77%	11.76%	12.32%	10.15%	10.27%	9.29%	8.65%	9.56%
Grant in % of State Budget	3.92%	3.90%	4.00%	5.32%	6.16%	4.80%	5.02%	4.40%	3.58%	3.40%
General State Budget revenues as % of GDP	25.20%	25.60%	27.13%	25.41%	25.34%	27.07%	25.61%	25.50%	22.24%	22.41%

In the context of preparing the Midterm Budget Program, (instruction no.20/1, date 26.02.2009) it is predicted an increase in total transfer fund compared to previous year: 7% in 2010, 10% in 2011 and 10% in 2012. But instruction no. 7/1, date 22.02.2010 "On the local budget preparation" assigns an increase of the fund: 3% in 2011, 7% in 2012 and 9% in 2013. Moreover, current figures show that in 2010 the transfer fund is reduced and it is not increased by 7% as expected. Thus, the fund to be transferred to local governments remains unknown until state budget law is approved.

Total local government revenues as a percentage of GDP and the state budget displays a modest growth trend throughout the period, although there are two periods of significant decline of these two indicator: year 2005 and

2011-2013. The growth and relative stability of this trend are positive indicators suggesting that the national government is trying to improve the condition of local government units. Despite this increase, the percentage of local government revenue to the state budget, as well as to GDP, is low compared to the European or even regional standards. As presented in Table 1, the local government revenues in Albania for years 2011-2013 represent about 8% of the state budget. For the period 2007-2010 this figure was higher, about 11% of the state budget; yet under the European standard of comparison. Local government revenues as part of GDP result to be only 2.12% for the year 2012. However, it should be understood in the context of the total government sector in Albania, which is small in relation to GDP, only 25%. Compared to European rates of 35% to 45%, the difference derives from the fact that Albanian government faces many problems in collecting taxes.

The Unconditional Transfer Distribution Formula

Once the total transfer fund is determined, the amount is distributed to local government units according to the formula (based on law 8847/2000 "On State Budget for 2002"). As it can be seen from Table 2, the formula has changed continuously over the years. The formula components for the allocation of funds consist of: (1) an equal fund for all municipalities and municipal districts, during the period 2002 to 2004. After this year, this component is removed, (2) population of local government units. This is the main component of the formula, 70% from 2006, (3) the geographical area of each municipality; (4) urban population for municipalities; (5) a special coefficient for Tirana (capital) for the period 2002 to 2004; (6) fiscal capacity adjustments and other adjustments (transitional arrangement). Fiscal capacity is adjusted after the above components are calculated and the result is corrected to reflect changes in fiscal capacity and transitional arrangements.

Table 2: Unconditional Transfer Distribution Scheme 2004-2013

Division of the Total Fund	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
Districts	9%	9%	8.50%	8.50%	8.50%	9%	9%	8.50%	9%	15%
Municipalities	91%	91%	91.5%	91.5%	91.5%	91%	91%	91.50%	91%	83%
Compensation fund	-	-	-	-	-	-	-	-	-	2%
Division for the municipalities/communes										
Formula	100%	100%	100%	100%	100%	100%	100%	100%	100%	94%
Compensation fund	-	-	-	-	-	-	-	-	-	6%
Formula for the municipalities										
Equal amount fund	-	-	-	-	-	-	-	-	-	4%
Population	70%	70%	70%	70%	70%	70%	70%	70%	73%	62.5%
Area of municipalities	15%	15%	15%	15%	15%	15%	15%	15%	12%	9%
Urban population	15%	15%	15%	15%	15%	15%	15%	15%	15%	18%
Coefficient of Tirana (capital)	-	-	-	-	-	-	-	-	-	6.50%
Fiscal equalization	25%	25%	25%	25%	25%	25%	25%	30%	35%	Po
Other adjustments	Po	Po	Po	Po	Po	Po	Po	Po	Po	Po
Division of funds for districts										
Formula	99%	99%	99%	99%	99%	98%	98%	98%	98%	97%
Compensation fund	1%	1%	1%	1%	1%	2%	2%	2%	2%	3%
Formula for districts										
Equal amount fund	10%	10%	10%	10%	10%	10%	10%	15%	15%	15%
Population	28%	28%	28%	28%	28%	28%	28%	25%	25%	25%
Geographic indicators	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%
Length of highways/roads	32%	32%	32%	32%	32%	32%	32%	30%	30%	30%

Meanwhile, the equalization coefficients have changed over the years and they do not become known until the organic budget law is approved. Even though the scheme for the formula calculations is predetermined in the instruction of the budget law, the source for the estimated data is not declared. So for figures taken into account such as: population,

land surface and urban population, it is not clear whether they are based on Population Data Registry or Institute of Statistics data, two very variable sources since they use different methodology and assumptions.

The main weakness in the unconditional transfer system is the unpredictability of fund distribution. This is partly due to the annual budget negotiations which determine transfers and also due to the continuous changes in the formula coefficients. The result is a high degree of uncertainty which undermines local budgeting and redundant role of short-term political considerations in determining the distribution of funds.

General Accepted Criteria for the Unconditional Transfer System

Unconditional transfer system must fulfill the following criteria: autonomy, income adequacy, equality, predictability, efficiency, simplicity, and incentives for a sound fiscal management. However, there are many limitations in the application of these criteria in practice which can damage the long-term welfare of system, especially regarding to elements of local autonomy and fiscal equality.

Autonomy

By definition, local governments have the responsibility and autonomy to decide how to spend the unconditional transfer fund. However, law no. 10355/2010, sets out restrictions for the unconditional grants to be used as part of operating expenses (salaries, social security, etc). This is an evidence for the impaired autonomy criterion of unconditional grants.

Revenue Adequacy

In nominal terms, the total transfer increases unless more taxes are delegated to local units. Exceptions are noted in 2006, when the government injected substantial amounts of money in the form of conditional transfer or competitive grants and sought to limit local government taxation for small businesses by halving the tax base of small business. In 2010, the total transfer was reduced and the central government placed some limits on local taxes. Taking into account these developments, it can be concluded that the transfers do not meet the criteria of adequacy of income during the interval of study.

Equality

It is reflected in the formula by adjustment of fiscal capacity. Also, equality is further insured through the use of minimum per capita adjustment, compared with the national average. Regarding the equalization criteria, the formula faces a problem because tax capacity is measured based on actual collections of both taxes and it is not based on the real taxation capacity. Moreover, the distribution of per capita transfers is increased over the years 2008-2010, but the coefficient of variation is still low. However, while the real tax capacity for each local unit is difficult to calculate, it can be said that the actual formula tends to approach equalization.

Predictability

The parameters that determine the amount of the transferred fund are neither fixed nor stable. Local governments find out the exact amount of transfers only when the state budget is approved. Although local governments can approximately forecast the total transfer, the inconsistency of locally and nationally data, as well as changes in the equalization coefficients, make it inconvenient to calculate the fund for the local unit. With regard to the given argument, the transfer system does not meet the criteria of predictability.

Efficiency

The autonomy of local leaders to decide how the funds will be used does not always imply an efficiency of the system. Whether funds are used efficiently depends on the willingness and competence of local leaders. It would require further studies and investigation to evaluate the system on the criterion of efficiency.

Simplicity

The formula is defined by the law of budget, but the coefficients, especially those of equality and transitional arrangements have changed during the period. The formula still uses updated data and information at the national level that are often different to those at the local level. In this regard, the formula is considered average at the scale of simplicity.

Incentives

The equalization component of the formula tends to discourage resource mobilization since those local units with higher per capita transfers compared to national average, contribute to the local units which have lower transfers than the national average. Also, after the results of fiscal equalization, those municipalities or communes that benefit transfers over 87.23% (in 2010) compared to 2009, contribute to the minimum guarantee fund and to the compensation fund for the amount over 87.23%. On this aspect, transfers do not meet the criteria of incentives.

The general fund of unconditional transfer depends on the growth of state budget and the delegation of functions and competences to local governments. Regarding the scheme of distribution, it is important to declare the resources and data used in calculation of the formula, so local and central government will use the same data for the estimation of transfers by making the fund more predictable.

CONCLUSIONS

The empirical analysis conducted on the study of intergovernmental fiscal transfer system of Albania for the interval of time 2003-2014, reveals the following conclusions:

- The method of determining the total transfer fund for the local government is uncertain. The total fund results to be unstable during the period of study and it remain unknown until budget law is approved each year.
- The percentage of local government revenue to the state budget, as well as to GDP, displays a modest growth trend throughout the period 2004-2013. However, these two indicators are below the European and regional standards.
- The main weakness in the unconditional transfer system is its unpredictability, due to: the annual budget negotiations for determining the transfer fund and the continuous changes in the formula coefficients.
- There is an inconsistency in the sources of locally and nationally estimated data in the formula of fund distribution, which lowers the transparency of the system and hinders the prognosis of revenues by local governments.
- There are evidences of impaired criteria of: local autonomy, revenue adequacy and incentives for a sound fiscal management. However, the formula is considered of average simplicity and approaching equalization.

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